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IN THE

Supreme Court of The United States

OCTOBER TERM, 1944

No. 1295

CLARION OIL COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA.

The petitioner, Clarion Oil Company, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia in the above case reversing a decision of The Tax Court of the United States.

OPINIONS BELOW

The opinion of The Tax Court (R. 13-26) is reported in 1 T. C. 751. The opinion of the United States Court of Appeals (R. 28-36) is reported in ..... F. (2d) .....

JURISDICTION

The judgment of the Court of Appeals was entered on March 12, 1945. (R. 37) The jurisdiction of this Court is invoked under section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925. (U. S. C., Title 28, section 347(a); see also U. S. C., Title 26, section 1141(a).)

QUESTION PRESENTED

Is a cash bonus received by the assignor of an interest in an oil lease a royalty and therefore personal holding company income within the meaning of section 353(h) of the Revenue Act of 1936, added by section 1 of the Revenue Act of 1937, c. 815, 50 Stat. 813?

STATUTES AND REGULATIONS

The Revenue Act of 1937, c. 815, 50 Stat. 813, provides in part as follows:

"SEC. 1. AMENDMENT OF 1936 ACT.

"Title IA of the Revenue Act of 1936 is amended to read as follows:

* * *

"SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

"There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

"(1) 65 per centum of the amount thereof not in excess of $2,000; plus

"(2) 75 per centum of the amount thereof in excess of $2,000.

"SEC. 352. DEFINITION OF PERSONAL HOLDING COMPANY.

"(a) *General Rule.*—For the purposes of this title and of Title I the term 'personal holding company' means any corporation if—

"(1) *Gross Income Requirement.*—At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 353; but if the corporation is a personal holding company with respect to any taxable year, then for each subsequent taxable year, the minimum percentage shall be 70 per centum in lieu of 80 per centum, until a taxable year during the whole of the last half of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 70 per centum of the gross income is personal holding company income; and

"(2) *Stock Ownership Requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

* * *

"SEC. 353. PERSONAL HOLDING COMPANY INCOME.

"For the purposes of this title the term 'personal holding company income' means the portion of the gross income which consists of:

"(a) Dividends, interest, royalties (other than mineral, oil, or gas royalties), annuities.

* * *

"(h) *Mineral, Oil, or Gas Royalties.*—Mineral, oil, or gas royalties, unless (1) constituting 50 per centum or more of the gross income, and (2) the deductions

allowable under section 23(a) (relating to expenses) other than compensation for personal services rendered by shareholders, constitute 15 per centum or more of the gross income.

* * *

"SEC. 3. EFFECTIVE DATES.

"The amendment made by section 1 shall apply only with respect to taxable years beginning after December 31, 1936; * * *."

Treasury Regulations 94, promulgated under the Revenue Act of 1936, as amended by T. D. 4791, 1938-1 C. B. 83, 102-104, to accord with the Revenue Act of 1937, provide in part as follows:

"Art. 353-1. *Personal holding company income.*—The term 'personal holding company income' means the portion of the gross income which consists of the following:

* * *

"(11) *Mineral, oil, or gas royalties.*—

* * *

"The term 'mineral, oil, or gas royalties' means all royalties, except overriding royalties, received from any interest in mineral, oil, or gas properties. The term 'mineral' includes the ores specified in paragraph (d) of article 23(m)-1. As used in this paragraph the term 'overriding royalties' means amounts received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid."

STATEMENT

On April 6, 1933, the owners of certain land in Texas gave an oil lease thereon reserving a ⅛ royalty. The lease was to lapse on November 30, 1938, unless oil were being

produced or drilling operations were in progress on that date. On November 29, 1933, the petitioner acquired by assignment an undivided ¾ of the lessee's interest in the lease. There had been no drilling by July 3, 1937. On that date the petitioner assigned its interest in the lease to Humble Oil and Refining Company for a cash consideration of $120,000; an oil payment of $240,000 payable out of a share of any oil produced; and an overriding royalty of 1/32 of the oil which might be produced. Humble Oil and Refining Company drilled a dry hole and abandoned the property. The lease expired by its own terms on November 30, 1938. Since no oil was produced the petitioner received nothing from the lease or assignment except the $120,000 cash payment received in 1937. (R. 15-16)

In its income tax return for 1937 the petitioner included in income the aforesaid bonus payment of $120,000 and claimed with respect thereto (and was allowed) the percentage depletion deduction of 27½% thereof, or $33,000. (R. 16)[1] The Commissioner determined that the $120,000 bonus payment constituted either "rents" or "royalties" and was therefore personal holding company income within the meaning of subsections (g) and (h) of section 353 of the applicable statute; that since the other requirements of the definition of a personal holding company were admittedly satisfied the petitioner in addition to all other income and excess profits taxes was subject to the graduated surtaxes of 65% and 75% of its undistributed adjusted net income. (R. 20) The Tax Court held that the bonus payment was neither rent nor royalty and that therefore petitioner was not subject to any personal holding company surtax. (R. 21) On the Commissioner's appeal the Court of Appeals agreed with The Tax Court that the bonus payment was not rent. (R. 30) It held,

[1]Since the lease was abandoned in 1938 without any production, the Commissioner in a separate determination for that year restored to income the $33,000 deducted as percentage depletion in 1937. (R. 17)

however, that the payment was a royalty and accordingly the decision of The Tax Court was reversed. (R. 32)

SPECIFICATION OF ERRORS TO BE URGED

The Court of Appeals erred:

(1) In holding that the petitioner was a personal holding company as defined in Title IA of the Revenue Act of 1936 as amended by section 1 of the Revenue Act of 1937.

(2) In holding that the bonus payment received by the petitioner in 1937 was a royalty and therefore personal holding company income within the meaning of section 353(h) of the Revenue Act of 1936 as added by section 1 of the Revenue Act of 1937.

(3) In failing to hold that the decision of The Tax Court was entitled to the finality indicated by this Court in *Dobson* v. *Commissioner*, 320 U. S. 489.

(4) In failing to hold that the surtax on personal holding companies as applied to the petitioner for 1937 is unconstitutional and void in violation of Article I, Section 9, Clause 4, of the Constitution of the United States and the Fifth Amendment thereto.

REASONS FOR GRANTING THE WRIT

I

In Holding That A Bonus Payment Received Upon the Assignment Of An Oil Lease Was A Royalty and Therefore Constituted Personal Holding Company Income, the Court of Appeals Decided An Important Question of Federal Tax Law Which Has Not Been, But Should Be, Settled By This Court.

The importance of the question is clearly illustrated by this case. The Court of Appeals agreed that the personal holding company surtax "may be properly called a penalty tax." (R. 32) It was designed to prevent tax avoidance

through the device of the so-called "incorporated pocketbook." This petitioner, however, was organized in 1911 by two practical oil men who were drillers. Upon their deaths, the stock passed to their respective families with the result that in 1937 more than 50% of the stock was owned by or for not more than five individuals. (R. 15) Though this satisfied one of the requirements (section 352(a)(2)) the nature of the petitioner's income from normal operations was such that in no year prior to 1937 did it come within the personal holding company provisions. (R. 18) If, as the Court of Appeals held, the petitioner is to be subjected to this highly penal surtax in 1937, it is only because in that year it received a large non-recurring bonus payment upon the assignment of its interest in an oil lease.

The payment of such bonuses is common in the oil industry. If they are to be classed as personal holding company income, it is apparent that many companies whose operations are entirely outside either the spirit or the letter of the statute will, as in the case of this petitioner, be penalized in the year or years in which such large non-recurring payments are received. Such a result is not to be lightly attributed to Congress. Reasonable doubts should most certainly be resolved against the imposition of such an exaction. That such doubt exists is abundantly clear from the history of the question.

The Treasury regulations do not specifically provide that "mineral, oil or gas royalties" include bonus payments. The question first came before the Board of Tax Appeals in *Porter Property Trustees, Ltd.*, 42 B. T. A. 681, (1940). The Board concluded that a bonus "payable to the lessor in a definite sum and in no way contingent upon or payable from the production of oil or gas from the leased premises is not a 'royalty' within the meaning of section 351 of the Revenue Act of 1934." (p. 691) In July, 1940,

the Commissioner published his acquiescence in that decision. (1940-2 C. B., p. 6) That acquiescence continued for over three years. In August, 1943, the Commissioner withdrew it. (1943 C. B., p. 38) Though the Commissioner changed his mind, The Tax Court in the instant case adhered to its previous decision. (R. 21) The Court below admitted that the question presented difficulty and conceded that the term "royalty" in its "usual and ordinary sense" does not include a bonus payment. (R. 30) It concluded, however, that it was bound to depart from the usual and ordinary meaning of the term because of certain decisions of this Court dealing with the wholly unrelated subject of depletion.

II

In Holding That the Term "Royalty" As Used In Section 353(h) Should Not Be Given Its Usual and Ordinary Meaning, the Court of Appeals Misconstrued Certain Decisions Of This Court.[2]

In its usual and ordinary sense, a royalty is a share of actual production reserved to the owner for permitting another to exploit the property. A bonus payment in no way contingent upon or payable from production is not therefore a royalty within the usual and ordinary meaning of those terms. The correctness of these propositions is thoroughly demonstrated by the Court below. (R. 30) However, because this Court has held that under certain limited circumstances a bonus payment may be treated as advance royalty for depletion purposes, the Court of Appeals concluded that in the interest of uniformity it

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[2] *Burnet* v. *Harmel*, 287 U. S. 103
Murphy Oil Co. v. *Burnet*, 287 U. S. 299
Bankers Pocahontas Coal Co. v. *Burnet*, 287 U. S. 308
Palmer v. *Bender*, 287 U. S. 551
Herring v. *Commissioner*, 293 U. S. 322
Anderson v. *Helvering*, 310 U. S. 404

must be treated as a royalty for all purposes under the Federal Revenue Acts. We submit that the decisions of this Court, considered in their proper setting, do not support the conclusion of the Court of Appeals that the term "royalty" as used in section 353(h) was intended to include a bonus payment.

In this case, as is common in oil leasing transactions, the petitioner assigned its interest in consideration of (1) a lump sum in cash, commonly called a "bonus payment;" (2) a fixed additional sum payable out of a fractional part of the oil extracted, commonly called an "oil payment;" and (3) a percentage interest in production coextensive with the life of the lease, commonly called a "royalty payment." The proper method of treating these different kinds of payments for depletion purposes under varying states of fact has been the subject of many decisions by this Court. The basic concepts applied with respect to oil wells are that the depletion deduction is permitted in recognition of the fact that mineral deposits are wasting assets; that it is intended as compensation to the owner for the part used up in production; that it is allowable to anyone who has an "economic interest" in the oil in place which is depleted by production; and that "the language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." *Palmer* v. *Bender*, 287 U. S. 551, 557.

The results so far as the question here is concerned may be summarized as follows:

> (1) Where a lease is granted or assigned for a bonus payment plus a royalty interest in production coextensive with the life of the lease, the bonus is treated or regarded as advance royalty and depletion

is allowed with respect to both the bonus payment and the royalty. *Burnet* v. *Harmel*, 287 U. S. 103; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U. S. 308. See also *Anderson* v. *Helvering*, 310 U. S. 404.

(2) Where such a lease granted or assigned for a bonus payment and a royalty interest is abandoned or surrendered in a later year without any production, the amount of the depletion deduction conditionally allowed with respect to the bonus payment is restored to income in the year in which it is determined that there will be no production. *Douglas* v. *Commissioner*, 322 U. S. 275.

(3) Where a lease is granted or assigned for a bonus payment plus an oil payment the bonus is not even regarded as advance royalty. *Commissioner* v. *Fleming*, 82 F. (2d) 324 (C. C. A. 5th), G. C. M. 22730, 1941-1 C. B. 214, 217-218.

Because a bonus payment when included in a royalty lease is treated for depletion purposes as advance royalty the Court of Appeals concluded that "the word 'bonus' as used in oil leasing parlance is, in relation to federal taxation, included in the word 'royalty.' " (R.31) But this Court never held that a bonus payment is a royalty. As The Tax Court pointed out, this Court merely held that for the very special purpose of returning the capital interests of all parties who had an economic interest in the reservoir of oil in place, a bonus is "to be regarded as" and "in the nature of" advance royalty. (R. 21) A bonus payment is not even "regarded as" advance royalty unless it is coupled in a lease with a real royalty interest, but even then the treatment of the bonus as advance royalty subject

to depletion is purely conditional. If, as in this case, (R. 23) a bonus payment is treated as advance royalty and a depletion deduction allowed with respect to it, and thereafter the lease is abandoned without any production, then the amount of the depletion deduction is restored to income in the year of abandonment. *Douglas* v. *Commissioner*, 322 U. S. 275. We do not believe that such a special, limited and conditional treatment of a bonus payment as advance royalty was intended by this Court as a positive holding that a bonus payment is to be included within the term royalty when the latter term is specifically used in other and wholly unrelated contexts in the Revenue Acts.

Throughout the decisions dealing with this complicated subject of depletion, this Court has stated repeatedly that it was not concerned with the terminology used to describe the depletable interests. But as The Tax Court pointed out (R. 22) the real question presented in this case concerns the precise meaning of the terms used by Congress in defining personal holding company income. It is of course a fundamental rule of construction that words used in a Revenue Act are to be given their ordinary meaning, *(Helvering* v. *William Flaccus Oak Leather Co.*, 313 U. S. 247, 249) unless Congress has definitely indicated that they are to be construed otherwise. *Avery* v. *Commissioner*, 292 U. S. 210, 214. By its own admission, the Court of Appeals failed to construe the term "royalty" in its "usual and ordinary sense." (R. 30) In failing to so construe a term having a common and accepted meaning we submit that the Court of Appeals has misconstrued the decisions of this Court with the result that it has extended a highly penal statute to embrace sources of income not intended by Congress.

III

In Reversing The Decision of The Tax Court, The Court of Appeals Ignored The Admonition of This Court in Dobson v. Commissioner, 320 U. S. 489.

In the *Dobson* case this Court reviewed at length the problems presented by the judicial review of Tax Court decisions and admonished the reviewing Courts that their "judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body" [p. 501] and that:

> "In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter. The Tax Court is informed by experience and kept current with tax evolution and needs by the volume and variety of its work. While its decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible." [p. 502]

In this case The Tax Court held that the bonus payment received by the petitioner in 1937 was "not in fact and in law a royalty." (R. 21) It may be fairly contended that this determination involved a mixed question of law and fact. But even if it be regarded as a question of law, it can not be said that there was no "warrant in the record" or "a rational basis" for the conclusions of The Tax Court. Clearly, the Commissioner himself thought that there was a rational basis for the view of The Tax Court when for three years he acquiesced in an earlier decision to the same effect. [See p. 8] Even the Court of Appeals admitted that the question presented difficulty (R. 30) and conceded that The Tax Court had construed the term "royalty" in its "usual and ordinary sense." (R. 30)

The reason given by the Court of Appeals for not conforming to that conclusion was that in its opinion greater uniformity would be produced by a reversal. (R. 30-31) Yet this Court specifically pointed out in the *Dobson* case that because of the experience of The Tax Court and its competence in the specialized field of taxation "uniform administration would be promoted" by following its decisions where possible. [p. 502]

CONCLUSION

It is respectfully submitted that this petition for a writ of certiorari should be granted.

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